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C O N F I D E N T I A L SECTION 01 OF 05 TEGUCIGALPA 000463

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COMMERCE FOR MSELIGMAN AND WBASTIAN
STATE PASS USTR FOR AMALITO

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TAGS: EPET ENRG PREL BBSR NI VE HO
SUBJECT: HONDURAN FUEL SOLICITATION: FOOL ME TWICE, SHAME
ON ME

REF: A. A) TEGU 368 AND PREVIOUS
¶B. B) 06 TEGU 1881

Classified By: AMB Charles Ford for reasons 1.4 (b,d)

¶1. (C/NF) Summary: The GOH has decided to put the fuel solicitation process on a back burner. While this offers hope the planned state takeover of the fuel import sector might never take place, it leaves the plan with enough life in it for the Zelaya administration to play political games with it indefinitely, continuing to make life miserable for the current group of fuel importers. On March 2, the GOH reneged on nearly all it had promised over the last month about moving towards a competitive market in fuels. At the March 2 meeting the GOH announced it would continue the fuel import solicitation process (designed to monopolize the sector under state control), continue negotiations with ConocoPhillips (the firm that would supply the state under the nationalization plan), and move forward with a plan for the state to construct a two million barrel fuel storage facility (the last piece needed to move forward with nationalization). At the meeting the GOH also implicitly rejected the international oil companies' (IOC) proposals for reforming the fuels pricing formula, mandating instead that the pricing structure would remain as it is. Pricing adjustments will not be made more flexible or efficient by allowing them to move with the market price, but will instead remain in the hands of the state-run Petroleum Administration Commission (CAP), which will continue to set prices every two weeks. Finally, the GOH called on all supporters of the solicitation/nationalization scheme to rejoin the GOH in its efforts, apparently extending an olive branch to Juliette Handal and the Patriotic Coalition. As of March 13, two IOCs have now filed suit against the GOH, chief negotiator Arturo Corrales has refused to play any further part, and Minister Flores Lanza could provide no indication that the GOH has a clear vision of how to prevent what could be a coming train wreck. The decision now lies with the IOCs whether this issue must move to a legal or trade complaint venue for its resolution. End Summary.

¶2. (C/NF) The March 2 meeting had originally been scheduled for February 27, and was generally expected to be the venue where President Jose Manuel "Mel" Zelaya Rosales would unveil his new plan to create competitive fuel markets. Given his strong public statements over the last month, Post also expected that the meeting would be the decisive showdown with Handal, in which the President would once and for all assume a leadership role in the process and marginalize Handal and her disruptive Coalition. However, we and other observers became increasingly concerned when the GOH postponed the meeting and stopped returning calls, leaving all to wonder what would actually be presented. The meeting was then moved to March 2, a day when Zelaya himself would be out of the country, another ill omen. Despite these red-flags, the IOCs and other participants had little option but to watch and wait.

¶3. (C/NF) Representatives of ChevronTexaco -- the U.S. firm that has been most engaged in seeking a mutually acceptable outcome to this situation -- described the meeting as "very bad," and is considering seeking a meeting between their President and President Zelaya to convey its concerns. ExxonMobil requested a meeting between its corporate President and President Zelaya to express its grave concerns, and has quietly retained counsel, should it need to pursue a legal case. Even Arturo Corrales, repeatedly put forward as Zelaya's personal representative to these talks, told EconChief he felt "disappointed and deceived" by the outcome. (Note: Corrales was not present at the meeting, and it is rumored that the current public attacks on his meter-reading business, SEMEH, are in retaliation for his role in seeking a market-based solution to the fuels issue. On March 5, the GOH announced that his contracts would be unilaterally cancelled.

End Note.) Minister Enrique Flores Lanza -- who presented the GOH position at the March 2 meeting -- refused for several days to return calls made to either his office or personal phones. When reached on March 5, Flores Lanza claimed that the new GOH position was entirely consistent with the pro-liberalization stance and was little more than an attempt to create some political room for maneuver while moving towards free markets. (Comment: For all the reasons outlined below, Post does not find this explanation credible. End Comment.)

¶4. (C/NF) The meeting itself was reportedly primarily a media show. The GOH invited not only the IOCs, but also representatives from throughout the fuels distribution chain (those most opposed to liberalization, since it would threaten their padded margins) and even representatives of the taxi drivers' union. The taxi drivers' union, recall, was the blunt object with which Handal battered the GOH in late 2005 and early 2006, paralyzing the city with road blockages and precipitating adoption of the nationalization plan. The absence of Zelaya and Corrales at the meeting, and the presence of several vocally anti-liberalization groups clearly stacked the deck against any market-based outcome. (Comment: Interestingly, Handal herself was not present. Rumor has it she was touring the countryside, drumming up grass-roots support for a possible run at the Presidency. End Comment.) Mario Canahuati, former Ambassador to the U.S. and President of private sector umbrella group COHEP, was also present at the meeting, allegedly to represent the interests of the private sector. In our view, Canahuati is already campaigning for President, and emerged from the meeting to declare unhelpfully that he has always supported the Patriotic Coalition but also price reform, and that he favors increased competition in the sector, but also the GOH plan to construct the new fuel storage facility.

¶5. (C/NF) The meeting produced a seven-point communique, which appears in every respect to be a rout of market reform and liberalization.

(Point 1) The GOH will maintain the current pricing formula.

Analysis: Reforming this formula (especially in light of continuing losses being absorbed by the IOCs) had been the key focus of over a month of quiet talks between the GOH and the IOCs. No mention of any current or future reform is made in the communique, calling into question the GOH's good faith in engaging in those talks.

(Point 2) Negotiations with ConocoPhillips will continue.

Analysis: These talks had all but ended by February 24, and the GOH had successfully laid the blame for the breakdown on the U.S. citizen consultant and on Conoco. Conoco's only role in this process would be as monopoly supplier to a GOH-run national fuel import regime. Restarting these talks therefore has only one obvious purpose: to allow the GOH to once again pursue a nationalization scheme.

(Point 3) The bid solicitation process will continue and the GOH will seek court authorization to take over DIPPSA's privately-owned fuel storage facility.

Analysis: Obtaining control of these fuel tanks would allow the GOH to move forward with its state-controlled fuel import plan. Fifty percent of one storage facility is property of ExxonMobil, so there are potential implications for U.S. investor rights in such a decision. Because the current lawsuit is based on a clause in a contract that Exxon became party to when it purchased its stake in the tank farm, however, the legalities of such a decision are unclear.

(Point 4) The current state-run fuel pricing mechanism will not be reformed, but instead will remain in the hands of the

GOH's Petroleum Administration Commission (CAP).

Analysis: Prices will adjust only once every two weeks, and that decision must be approved by the political authorities within the GOH (at times, this has meant requiring approval by the President himself). The CAP is presided over by Lucy Bu, a long-time ally and former special assistant to Juliette Handal.

(Point 5) The GOH will move forward with a plan to build its own 2 million barrel fuel storage terminal.

Analysis: Industry experts, including the U.S. consultant who proposed this scheme in the first place, admit that there is already an oversupply of fuel storage in Honduras. There is therefore no economic justification for this new project. Rather, building these tanks appears intended solely to give the GOH the freedom to pursue its intended position as sole importer of fuels into Honduras. In short, this project is a clear signal that the nationalization scheme has not been rejected, but merely postponed until the GOH has all the pieces in place to make it happen. As for the existing privately-owned storage tanks, which would become stranded assets under such a scheme, the U.S. consultant once told Post, "They (Esso, DIPPSA, and Texaco) can sell their tanks for razor blades."

(Point 6) Any market reform will happen only in the medium-term, and only after a full discussion among all involved sectors.

Analysis: Post supports both transparency and participatory decision-making, but in the context of this document and given the participants to this meeting, this point appears to signal that the GOH is prepared to put off adopting market-based reform indefinitely. The lukewarm language and long timelines in this point are jarringly discordant with the pro-market rhetoric Zelaya had been invoking recently.

(Point 7) The full text of point seven reads: "We call on all sectors, organizations, and persons who have supported this

process to continue supporting the government in its efforts to find more favorable alternatives and fair fuel prices for the Honduran people, based the laws of the free market."

Analysis: Given the composition of the audience and in the context of all of the above, point seven is perhaps the most disappointing. In it, the GOH appears to extend an olive branch to the Patriotic Coalition, the taxi drivers' union, and all the other anti-reform elements that had until recently driven this process towards state-control. Where the GOH had been on the verge of dealing a decisive blow to this group, it now appears the GOH has instead once again empowered them. This is certain to re-ignite the underlying dispute and to protract any resolution for months or perhaps years. By that time, with its own storage tanks in hand, the GOH could decide to simply take over the sector itself. Despite this point's token mention of the free market, the "process" to which this point refers is one aimed at increasing state intervention in the sector, and when those that supported this process think of "more favorable alternatives" they are not thinking of price efficiency and competition, but rather of state controls and subsidies.

¶6. (C/NF) On March 9 EconChief followed up with Corrales, who admitted he "could not say he was optimistic." Corrales "hoped and prayed" the GOH would do the right thing, since he did not see what other alternative it has, but he said its actions over the last week have been like "running back into a burning building you've just escaped." Corrales said if the GOH is to have any hope of salvaging the situation, it must immediately undertake to reform the pricing formula, explicitly and publicly end the nationalization process and the solicitation for a monopoly fuels provider, and engage

the IOCs in talks on liberalizing the fuels sector. Even if the GOH were to do all of that, he said, it is unclear if it could repair the damage done. Corrales agreed with EconChief that the GOH by its action destroyed whatever credibility it had with the IOCs. Two of the IOCs (Shell and Trafigura) have now filed suit against the GOH, and at least one other (Esso) has retained counsel.

¶7. (C/NF) Post sees little that could entice the IOCs back to the table to negotiate with a government in which they no longer have any faith. Corrales agrees, and told EconChief that he has refused the President's request to play the intermediary in any attempt to re-engage with the IOCs. He said his credibility with the IOCs had been destroyed by the GOH's actions and that if he were to re-engage he would appear to the IOCs to be complicit in the GOH's duplicity. On March 13, Minister Flores Lanza told EconChief that he understood the IOCs have likely lost faith in the process and agreed that the GOH must move beyond words to actions. That said, two weeks have passed and the GOH has not yet decided how it plans to proceed. Flores was unwilling to commit to more than saying the GOH will work to clarify its position, perhaps over the coming week. Ambassador and EconChief have each made it clear to the GOH that Post put its credibility on the line in bringing the IOCs to the table, and we were gravely disappointed by the GOH failure to follow through on its commitments from those talks. As a consequence, we are no longer in a position to offer informal policy advocacy on this issue. In our view, the decision now lies with the IOCs whether this issue must move to a legal or trade complaint venue for its resolution.

¶8. (C/NF) Comment: When he first came into office in January 2006, Zelaya talked a great game about free markets and international trade, and we believed him. Yet from the time of CAFTA's April 1 entry into force, Zelaya has done little to act on his words, and much to call into question his real dedication to free markets (detailed extensively ref B). Yet, when Zelaya claimed in January 2007 to have embraced free markets as the solution to his fuel sector concerns, we again believed him. Once again, his government's actions

belie his words. We are deeply disappointed that Zelaya has again failed to marshal the political will to make the right choice. Worse, he led all participants to believe he would carry out this plan. They invested a great deal of time and prestige in a good faith effort to negotiate a mutually acceptable solution, only to find themselves ambushed once again at a media circus event, as if we were back in the bad old days of summer 2006. Worse, the GOH inviting the most disruptive elements back into this process suggests that Zelaya has returned to form -- provoking crises in order to ride to the rescue, yet unwilling to spend the political capital to avoid such crises in the first place.

¶9. (C/NF) Comment, continued: The historical precedents are ominous. Zelaya, for example, twice undercut his own negotiating teams in the 2006 wage dispute with teachers. In each case, Zelaya encouraged the teachers to reject the deal his own negotiators had put on the table and press for more. The crisis dragged on and three successive negotiating teams were formed and then replaced. Finally, Zelaya acceded to every demand the teachers had made, despite the severe fiscal dislocations that decision implies for future GOH budgets. If this analogy of the teachers talks holds in the fuels case, it suggests Zelaya does not actually intend to resolve this matter. He might instead allow it to smolder indefinitely, and perhaps even stoke the fire from time to time when it seems politically expedient to do so. This might be the normal game played in Honduran domestic politics, but the IOCs cannot continue for much longer down this path while losing money each day and living in a world of uncertain investor protections. February's last-ditch negotiations were a leap of faith by the IOCs, and it now appears that faith might have been repaid with betrayal.

Unless Zelaya were to reverse this latest policy shift, Post does not see how this process can be saved, and even that might not be enough.

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